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SUBJECT: IS ICELANDIC GOVERNMENT DOING ENOUGH TO HALT ECONOMY'S
SUDDEN DOWNFALL?

11. (SBU) Summary: Iceland's economy has recently gone wobbly, with the currency depreciating to a near record low and consumers facing sudden price hikes of near ten percent. In response to inflationary pressures, the Central Bank raised its prime rate 1.25 percent on March 25 to a new record high of 15 percent. International media commentary on Iceland's financial sector may be fueling much of the anxiety. To calm jitters, government officials argue publicly that the economy has faced the worst and is now on the upturn. The Central Bank also accused foreign speculators of trying to bring down the financial system, and called on Iceland's Securities and Exchange Commission equivalent to pursue lawsuits. It is still unclear if the government will be successful at positively influencing the situation. So far, the results are uneven at best: two foreign ratings companies recently changed their outlook on Iceland's sovereign credit rating to negative, with one directly citing the lack of information on Iceland's strategy to address economic policy issues. End Summary.

12. (SBU) Iceland's economy has been in turmoil in recent months. The Icelandic stock market has lost 32 percent of its value over the last year, which has affected access to credit through leveraged loans. The Icelandic krona, which some experts say was overvalued to begin with, depreciated 20 percent to reach a near historic low index, even against the US dollar. Although Icelandic fish exporters rejoiced (fishing remains the largest sector of the economy), most consumer goods are imported and the media was quick to highlight instantaneous 10 percent price hikes. Director of University of Iceland's Economic Institute Gunnar Haraldsson told us that despite little exposure to the global subprime mortgage market, Iceland's financial sector is suffering from worldwide tightening of credit, and the resulting slowdown is coinciding with a forecasted slowdown related to the scheduled completion of capital intensive energy and aluminum smelter projects.

13. (U) On March 25, in response to inflationary pressures and the depreciating krona, Iceland's Central Bank Board met in an emergency meeting and raised the interest rate 1.25 percent to a new record high of 15 percent. The krona and the stock market responded immediately, reversing slightly some of the losses. At the same time, government officials began a public campaign to bolster confidence in the economy. In a speech at the annual meeting of the Central Bank on March 28, Prime Minister Geir Haarde emphasized that Iceland's government has almost no debt, and the Treasury and Central Bank could provide assistance should the need arise. During Haarde's address to the Parliament on March 31, he stated the bottom of the devaluation of the krona had been reached. Haarde allowed that the devaluation had been faster than anyone had expected but was sure it would not last. He has also given a series of upbeat interviews with the Financial Times to counter generally negative

international coverage.

¶4. (U) Meanwhile, the search for scapegoats is well underway. On March 30, the Central Bank asked the Financial Supervisory Authority (Iceland's equivalent to the Securities and Exchange Commission) to investigate foreign investors who "attacked" the krona for speculative gains. The media reported the next day that British investor Hugh Hendry of Eclectica Asset Management had gloated in 2006 that he would become famous for bringing down the krona. The Prime Minister told the media on April 1 that Iceland was considering all options available to influence the financial situation. He emphasized that foreign investors were to blame and that Iceland would consider "setting a bear trap" to punish them.

¶5. (U) The idea that foreigners are responsible for the economic mess is a welcome distraction for Icelandic consumers, many of whom have, in addition to paying higher prices for food and consumer goods (most of which are imported), acquired foreign currency car loans and mortgages. These loans, typically in Swiss Francs or Japanese Yen, are low in interest but carry the risk of currency fluctuations. With the sudden krona depreciation, consumers are seeing their monthly payments rise immediately. Truck drivers began daily traffic-snarling protests all over Iceland on March 27 against spiking diesel prices.

¶6. (U) Notwithstanding the government's spin attempts, international attention remains on the situation. In the New York Times on March 31, Paul Krugman blogged about the krona speculation and likened it to the situation with Hong Kong in 1997-1998. During the April 2 Congressional testimony, Federal Reserve Chairman Ben Bernanke was asked about Iceland and speculative hedge funds. The markets appear to be equally concerned: on April 1, both Fitch and Standard and Poor's changed their outlook on sovereign credit rating to negative, with the latter directly citing a lack of information on Iceland's strategy to address economic policy issues.

¶7. (SBU) Comment: Only time will tell if the government will be successful at positively influencing the situation. Experts at the University of Iceland and the Ministry of Finance tell us that much depends on the global availability of credit. Haarde's government has its work cut out. It may take more than a few pep talks to repair investor confidence.

Van Voorst